Asian Shadow Financial Regulatory Committee
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Financial Globalization and its Effects on Local Markets

Financial globalization results from opening capital markets to cross border capital flows. Institutional developments associated with financial liberalization include improvements in the system of financial regulation, such as more transparent accounting and disclosure standards, the adoption of a better macroeconomic policy regime, such as more responsible fiscal policy and an exchange rate regime compatible with more open capital accounts, improvements in the legal system such as clearer bankruptcy procedures, etc. The benefits of financial globalization include greater economic efficiency arising from the better allocation of capital, access to cheaper capital and high return savings instruments, greater liquidity, portfolio risk diversification and consumption smoothing. Many economies in Asia liberalized their financial markets beginning in the early 1990s. In contrast with the situation two decades ago, Asia today is a net exporter of capital to developed countries. Asian savings, reflected in large current account surpluses, are largely intermediated in global financial markets and then return to Asia in the form of predominantly private capital flows. Indeed, many studies point out that economies in Asia are more integrated with global financial markets than they are with regional financial markets. The extent of regional financial integration is evidently mainly due to increased regional trade integration. Asian currencies are generally experiencing appreciation relative to the US dollar. Asian economies appear to be operating in a benign environment without any apparent threat of another financial crisis in the foreseeable future.

Nevertheless, there are risks associated with financial globalization that may adversely affect outcomes for economies in Asia. The potential risks from financial globalization are further exacerbated when coupled with financial innovation. Financial innovation gives rise to new instruments, such as structured financial products that allow securitization and bundling and unbundling of risks, which in turn enhances the liquidity of these financial instruments. This induces very high leverage and interconnectedness among financial products and financial markets. The combined effects of these could substantially increase local market volatility, possibly leading to financial crisis.

Moreover, two prevailing features of foreign financial institutions in emerging market investments may exacerbate the potential risks discussed above. The first is the asymmetric incentive structure of investment managers. Fund managers and traders in global financial firms often receive six to seven figure annual bonuses when their risk taking strategies succeed, but may simply quit their jobs when they fail. Such an incentive structure tends to encourage excessive short-term risk taking. The second feature is the tendency of foreign institutions to lump all emerging markets into one asset class. Foreign investment firms increase their investments in emerging markets in order to pursue opportunities for higher return in a low interest environment. When the competition among these investment firms lowers the spreads between yields on emerging market investments and their funding costs, they raise the size of their bets to maintain the same amount of absolute returns. Since many firms follow the same practice and exhibit herding behavior, asset price bubbles tend to develop. If one country's asset bubble bursts, the likelihood is high that investors will dispose of emerging countries' assets simultaneously, as these are regarded as belonging to one asset class, which may result in adverse price reactions across all emerging markets.

Emerging economies should seek to mitigate risks stemming from two types of adverse impacts of financial globalization: one from financial innovation and the other from the investment and management practices of global financial firms. First, regulators should not hastily allow the introduction of new financial instruments that are of the structured type with very high leverage but whose inherent risks are opaque. The decision to do so should be based not only on the skills of regulators themselves, but also on the financial maturity of domestic investors. Second, the government should deter excessive reliance on leverage. Derivatives, which play an increasingly prominent role in financial innovation and financial globalization, have inherently high leverage content. If leverage is used in financing investments with derivative content, the economy could become very vulnerable to financial shocks. Third, regulators should require foreign investing institutions to disclose the ultimate owners of these at the time of registration. By knowing the owners' identity and their investment and management practices, financial regulators could then better understand the incentives and potential impact of foreign investors on local markets. Fourth, governments in the Asian region should actively promote regional bond market initiatives such as ABF(Asia Bond Fund) and ABMI (Asian Bond Market Initiative) so that the surplus savings from the region could be more efficiently invested in the region through regional intermediaries that have more sound incentive structures.

Over the past five years, Asian financial markets have performed superbly in terms of growth and return. This has created a sense of euphoria among investors (and perhaps regulators as well) and attracted enormous flows of capital into the region. As a result, risks embedded in these external capital flows have intensified. This is precisely the time for policymakers to rethink their assumptions about the optimality of the situation in Asia today. They need to revisit and learn the important lessons from past financial crises here and elsewhere in the world. More importantly, policymakers today need to adopt a risk management approach to policymaking in order to reduce the risk of the occurrence of financial crisis and mitigate the adverse effects of financial globalization on local markets.